

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
REAL ESTATE SALE-LEASEBACK**

March 26, 1999

This Policy is effective immediately upon adoption and supersedes all previous real estate sale-leaseback investment policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for Real Estate Sale-Leaseback Investments ("the Program"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Program. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with this segment of real estate.

II. STRATEGIC OBJECTIVES

- A. Achieving the highest total rate of return possible, consistent with a prudent level of risk and the liabilities of the System and the investment guidelines contained herein, is the strategic objective of the program. The Program shall be considered a component of the Specialized Equity Real Estate Portfolio. As such, the Program shall achieve an appropriate risk-adjusted return. The System's sale-leaseback real estate investments (referred to herein collectively as the "Portfolio") shall be managed to assist the System in achieving its long-term objective of exceeding a minimum target real rate of return of 6.0% (after fees). Sale-leaseback investments shall achieve a real rate of return consistent with other equity real estate investments of similar risk.

The performance benchmark of shall be the National Council of Real Estate Investment Fiduciaries (NCREIF) or National Association of Real Estate Investment Trusts (NAREIT) indices, or other comparable indices or custom indices, if available. Target returns shall be based on the System's minimum 5% overall real return objective for the Core Real Estate Portfolio, with additional return requirements accounting for specific risks associated with sale-leaseback investments.

- B. The Program shall be managed to accomplish the following:

1. Provide diversification to the System's overall investment program;
2. Preserve investment capital and generate attractive risk-adjusted rates of return for the System;
3. Provide a hedge against inflation; and
4. Consider solely the interest of the System's participants and beneficiaries in accordance with California State Law.

III. PERFORMANCE OBJECTIVE

Target returns shall be based on the System's minimum 5% overall real return objective for the Core Real Estate Portfolio, with additional return requirements accounting for specific risks associated with sale-leaseback investments.

IV. INVESTMENT APPROACHES AND PARAMETERS

A. Risks

Primary risks associated with the Program are two-fold:

1. Tenant credit risk
2. Real estate risk

Tenant credit risks include risks associated with relying on the business success of usually one tenant and that tenant's ability to pay rent, other property expenses, and maintenance obligations of the property. Comprehensive evaluation of the credit-worthiness of the lessee, proper structuring of the lease includes financial covenants and event risk clauses. The continuous monitoring of the financial health of the lessee throughout the lease term can significantly minimize exposure to tenant credit risks. The structure of leases to corporations ensure a priority position to unsecured, general obligation bonds, which mitigates the risk of loss in bankruptcy.

The Program is also subject to the general risks associated with the ownership of real estate. Those risks include adverse changes in economic conditions, property supply and demand, as well as tax and environmental laws. In particular, functional and economic obsolescence, locational demise, environmental problems, and extensive specialized tenant improvements are all factors that potentially diminish the marketability of a sale-leaseback property in

the future. Of particular concern are factors such as a tenant's space needs, which impact the tenant's long-term commitment to a property. Real estate risks can be mitigated by comprehensive due diligence, real estate underwriting, and continuous monitoring of the real estate investments.

B. Diversification

Real Estate sale-leaseback investments of core properties shall follow the diversification guidelines for core properties as included in the Statement of Investment Objectives and Policies for the Equity Real Estate Portfolio. The System recommends the diversification of the Program by geographic region and property type. Additionally, the System shall seek diversification by industry type avoiding excessive concentration in one particular industry group for the core and specialized portfolios.

C. Investment Objectives and Criteria

1. Size

Real estate sale-leaseback investment size at the property or portfolio level shall depend on the opportunities available to the System, with neither small nor large investments dominating the Portfolio. The size of sale-leaseback investments shall be consistent with the guidelines included in the Statement of Investment Objectives and Policies for the Equity Real Estate Portfolio. Typically, individual sale-leaseback investments range in size from \$5 million to \$50 million, with portfolios of sale-leaseback properties ranging from \$50 million to more than \$300 million.

2. Structure

The Program shall have a standardized investment structure, although the competitive forces of the market place ultimately determine the final terms of the transaction. Therefore, investment advisors shall remain flexible in negotiating such agreements. The System and its counsel reserves the right to review and approve such agreements.

3. Vehicles

Direct investment is the preferred means of investing in the Program. Direct investment is favored over indirect fund investment due to the System's ability to commit sufficient

funds for diversifying its portfolio, achieving lower fees, and exercising increased control over the formulation of sale-leaseback investments.

4. Selection of Advisors and Management Firms

Investment advisor skills are critical to the success of the Program. The System shall invest in real estate sale-leaseback investments on a direct basis through its core investment advisors and managers selected for implementing specialized investment strategies where sale-leaseback structures are appropriate. Investment advisors shall have demonstrated expertise and experience in sourcing, negotiating, monitoring, and disposing of sale-leaseback investments.

5. Investment Criteria

Investment selection shall be oriented towards, but are not limited to, the following areas:

- a. Corporate headquarter office buildings;
- b. Data processing centers and other office facilities;
- c. Regional warehouse distribution facilities ; and
- d. Single tenant retail buildings.

Additionally, the following tenant, lease, and property characteristics are critical to the success of real estate sale-leaseback investments. In general, they shall be contained in the negotiated agreements. When agreements differ from these terms, the advisors or management firms shall identify the differences to the System.

- (1) **High Quality Credit Tenants** - Tenants shall generally possess the following; an investment grade rating (generally BBB and above, or the equivalent); favorable positioning in a stable or growing market or business niche; strong financial performance; favorable business prospects or outlook; and shall not be subject to excessive leverage. High quality tenants are critical to low re-leasing risk, which is important in investments in single-tenant buildings.

- (2) **Long-term Lease** - The lease terms shall generally range from 10 to 20 years. Leases of this length allow for the sale of the investment in years 5 to 10 with a marketable lease term remaining. Consideration of shorter leases may occur under special circumstances such as when properties possess below market rents, strong tenant demand, superior location, and/or expansion potential.
- (3) **Triple-net Leases** - Leases shall obligate the tenant to pay for all or substantially all operating expenses and capital expenditures.
- (4) **Rent Increases** - Additionally, the structure of leases shall include periodic rent escalations tied to the Consumer Price Index (CPI) or based on negotiated fixed increases. During periods of low to moderate inflation, these rent increases generally provide adequate inflation protection.
- (5) **Financial Covenants and Event Risk Language** - Leases shall contain financial disclosure and event risk clauses such as anti-dilution provisions and net worth tests for protection against loss of value because of a financial event that could diminish the credit-worthiness of the tenant. The structure of leases shall ensure that the tenant is required to pay rent under all circumstances. The lease structure shall protect the System from unexpected financial obligations in the normal course of operations as well as under troubled circumstances.
- (6) **Competitively Located Properties in Strong Markets** - Properties shall be well located in markets with favorable supply and demand characteristics.

6. Asset Management

The Program is generally less management intensive than other types of real estate investments due to the triple-net lease structure requiring that the lessee be responsible for

operating costs and capital expenditures. However, particular management requirements shall vary by property type.

Management firms shall represent the System's interests in asset management decisions and oversee or provide daily property management services, as expertise and organizational structure allows. Management firms shall receive the appropriate delegation of authority along with the responsibility for providing appropriate measures of accountability. Advisors shall represent the interests of the System only in these transactions or the interests of the investor group only if the System co-invests with other clients in such transactions.

Appropriate financial and operational controls and reporting requirements shall apply to real estate sale-leaseback investments. This shall include audited financial statements on a basis consistent with the System's accounting policy.

V. BENCHMARK

The performance benchmark of the Program shall be the National Council of Real Estate Investment Fiduciaries (NCREIF) or National Association of Real Estate Investment Trusts (NAREIT) indices, or other comparable indices or custom indices, if available.

VI. GENERAL

Real Estate sale-leaseback properties are typically single-tenant properties acquired and leased back to their former owners on a triple-net basis. They may be categorized as core or specialized investments depending on their risk-and-return attributes and the nature of the underlying real estate.

Real estate sale-leaseback investments have bond-like characteristics. They typically provide a stable, predictable cash flow, act as a moderate inflation hedge, and have lower volatility than multi-tenanted property investments due to the long-term contractual nature of their income stream. Additionally, triple-net leases obligate the tenant to pay for all, or substantially all, operating expenses and capital expenditures, thereby reducing the owner's exposure to unpredictable operating costs. Advantages to investing in real estate sale-leaseback properties include stable, predictable cash flows, and reduced volatility resulting from long-term leases and competitive income returns. Furthermore, long-term leases generally reduce the frequency of re-leasing risk, the cost of commissions and tenant improvements, and, often, downside exposure in a weak market.

Because of the lengthy term of most of the leases tied to these investments and their consistency of income stream, real estate sale-leaseback investments typically do not offer significant upside (appreciation) potential. However, during downturns in the real estate market, sale-leaseback investments shall commonly outperform core real estate due to their income orientation and credit quality of the tenants. During periods of real estate market recovery, these investments are likely to trail the benchmark indices because there may be no opportunity to re-lease a sale-leaseback property for higher rents.

VII. ASSET ALLOCATION

Allocations to the Program shall be consistent with allocation parameters for core and specialized investments in the Statement of Investment Objectives and Policies for the Equity Real Estate Portfolio. Additionally, the particular attributes of these investments (e.g., income versus growth orientation) shall be noted when making allocation decisions.